Taxation by Government of India: Objectives and Canons

Objectives of Taxation:

The major objective of taxation is to raise revenue. But certain other objectives are also important in the design of a tax system.

(i) Neutrality:

In many ways the market system works well. Adam Smith's invisible hand provides the consuming public with a steady flow of goods and services. As a starting point, therefore, a tax system should be designed to be neutral. That is, it should disturb market forces as little as possible.

(ii) Non-Neutrality:

There is, however, an important modification that must be made to the neutrality principle. In some cases it may be desirable to disturb the private market. The government might tax polluting activities so that firms will do less polluting.

The market is disturbed but in a desirable way. Another example is the tax on cigarettes, which, in addition to its prime object of raising revenue for the government, also discourages cigarette consumption. So there is the need to meet social objectives by imposing taxes.

(iii) Equality:

Taxes represent both sacrifice and compulsion. Therefore, it is important that taxes be both fair and give the appearance of being fair.

There are, however, two different principles for judging fairness, which are explained below:

(a) The Benefit Principle:

This principle recognizes that the purpose of taxation is to pay for government services. Therefore, those who gain the most from government services should pay the most. If the government follows the benefit principle of taxation it must estimate how much various individuals and groups benefit and set taxes accordingly.

The Benefit Principle simply holds that different individuals should be taxed in proportion to the benefit they receive from government programmes. Just as people pay money in proportion to their consumption of private bread, a person's taxes' should be related to his (or her) use of collective goods like public roads or parks. Those who receive numerous benefits should pay more than those who receive few.

However, this principle is difficult to apply in practice and it is normally observed that those who receive the maximum benefit from public expenditure pay very little — if any — tax. So another principle of taxation has been developed.

(b) The Ability-to-pay Principle:

It is the principle that states that individuals should pay taxes according to their ability to pay. If the government sets taxes according to this benefit principle it does not redistribute income. But if it sets taxes according to ability to pay, the rich should pay more than the poor. The ability-to-pay principle simply states that the amount of taxes people pay should relate to their income or wealth.

The higher the wealth or income, the higher the taxes. Usually tax systems organized along the ability-to-pay principle are also redistributive, meaning that they raise funds from higher-income people to increase the incomes' and consumption of poorer groups. An individual who earns Rs. 50,000 per month is able to pay more taxes than an individual who earns Rs. 2,500 per month.

If the government levies a progressive tax on income and wealth and, at the same time, provides assistance to poor people, it would substantially redistribute income from the rich to the poor.

However, this principle may be simple to state but it is not easy to implement. The government levies many taxes and most of these are proportional or even regressive. Overall high income groups pay only a slightly higher percentage of their incomes in taxes than do low income groups. It is on the expenditure side the government has its greatest effect in redistributing income.

Conclusion:

The basic object of taxation should be to ensure equality or fairness. This is of two types — horizontal and vertical. The former refers to the rule of taxation whereby equal income is taxed equally — no matter how it is earned.

According to the latter the rule of taxation should be such as unequal income is treated unequally — perhaps according to the ability to pay or to the benefits received. If the government is to achieve equity, a tax system should have certain desirable characteristics — known as the canons of simplicity, convenience, productivity and so on. Most tax systems are based on a realistic compromise among different principles and canons.

Canons of Taxation:

Tax is levied compulsorily in order to defray the expenses of the government. In the opinion of economists, collection of taxes should be based upon some principles or canons. These are also known as the qualities of a good tax system.

Adam Smith laid down the following canons of taxation:

1. Canon of Ability:

The State is necessary for all—rich and poor. Without the State, nobody's life or property is safe. So everyone is required to pay taxes to meet the expenses of the State. But a person who earns Rs. 50,000 a year has not the same taxable capacity as the person who earns Rs. 10,000 a year. The canon of ability states that a person should be made to pay taxes according to his ability to pay. If everyone pays according to his ability, there is equality of sacrifice. So this rule of Adam Smith is also known as the canon of equity.

2. Canon of Certainty:

The principle of certainty requires that the tax which every individual has to pay should be certain and not arbitrary. "The time of payment, the amount to be paid ought all to be clear and plain to the contributor and to every other person."

3. Canon of Convenience:

The time and manner of tax payments should be made as convenient to tax-payers as possible. The Pay- As-You-Earn (PAYE) method of collecting personal taxation under which an employer deducts tax on behalf of employees and pays it to the Finance Department is a good example of this quality. For this reason, the salaried persons are taxed at the source, that is at the source of income.

Some taxes are collected by installments so as to make it convenient for the tax-payer to make the payment in small amounts. On the other hand, self-employed people and companies have to put aside money reserves to pay the tax when they are assessed.

4. Canon of Economy:

According to Smith again — "every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the State." A tax whose collection involves high expenditure should be avoided. Taxes should be levied in such a way as to minimize the cost of collection in terms of resources collected. In modern times two other canons of taxation are also recognized as beneficial.

5. Canon of Elasticity:

A tax should be sufficiently elastic in yield. The amount of tax ought to be so contrived that it can be varied according to the needs of the government. For instance, the rate of income tax is variable. In modern times, all taxes and their rates can be varied.

The rate of income tax is liable to be changed according to the changes in the level of income of the people. The land revenue is, however, fixed for a period. It is not liable to be changed as is possible in the case of income tax. In case of crop failure, the government can, of course, grant remission.

6. Canon of Productivity:

All taxes should be productive. It is better not to impose a tax whose yield is negligible. The canon of productivity implies that taxes should be imposed in such a manner as not to hamper production or to decrease the volume of resources collected. In other words, the levy of a tax should not only increase the income of the State, it must not also destroy the incentives of the people to undertake productive enterprises.

Indian Tax Structure

Tax structure in India is a three tier federal structure. The central government, state governments, and local municipal bodies make up this structure. Article 256 of the constitution states that "No tax shall be levied or collected except by the authority of law". Hence, each and every tax that is collected needs to backed by an accompanying law.

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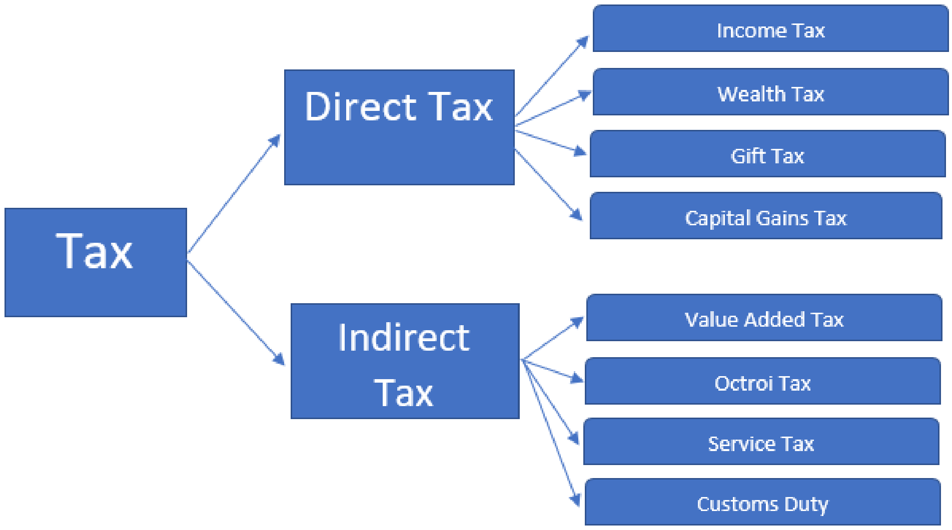
Interestingly, the tax system in India traces its origin to the prehistoric texts such as Arthashastra and Manusmriti. As proposed by these manuscripts, the taxes paid by farmers and artisans in that era would be in the form of agricultural produce, silver or gold. Based on these texts, the foundation of the modern tax system in India was conceptualised by the Sir James Wilson during the British rule in India in the year, 1860. However, post-independence the newly-established Indian Government then soldered the system to propel the economic development of the country. After this period, the Indian tax structure has been subject to a host of changes.

Tax System in India:

There are 3 tiers of government in India, these are union government (at the Centre), state governments (in the respective states) and local bodies/local governments (including Village Panchayat, Panchayat Samiti, Municipalities and Municipal Corporations) at the local level. Since the various layers of government operate simultaneously, confusion and financial conflict is a possibility. So as to minimise such disputes, there are guidelines or rules, regarding the distribution of the revenues and expenditures amongst the different layers of the government. The system or organisation of such rules is called 'federal finance' based on the meaning of 'federation' or 'federalism' denoting a system of government in which there is a splitting up of powers and functions between the different levels. Therefore, federal finance is a system of the financial relationship between different layers of governments (particularly Centre-State). The financial relationship between the Union & state governments is enshrined in the Constitution of India. The focus of this relationship is on distribution of authority between the Centre & states regarding: How to raise tax and non-tax revenues How to spend tax and non-tax revenues in the economy to enhance growth and development Some taxes are levied and collected by the Centre but shared with the States. These include taxes on income other than agricultural income & union excise duties on goods included in Union List, except medicinal and toilet preparations. Over the past 10-15 years, there have been tremendous reforms in the taxation system of India.

The **tax system in India** allows for two types of taxes—Direct and Indirect Tax.



The **tax system in India** for long was a complex one considering the length and breadth of India. Post GST implementation, which is one of the biggest tax reforms in India, the process has become smoother. It serves as an all-inclusive indirect tax which has helped in eradicating the cascading effect of tax as a whole. It is simpler in nature and has led to upgraded the productivity of logistics.

Direct Tax:

Direct Tax is levied directly on individuals and corporate entities. This tax cannot be transferred or borne by anybody else. Examples of direct tax include income tax, wealth tax, gift tax, capital gains tax.

Income tax is the most popular tax within this section. Levied on individuals on the income earned with different tax slabs for income levels. The term 'individuals' includes individuals, Hindu Undivided Family (HUF), Company, firm, Co-operative Societies, Trusts.

Indirect Tax:

Indirect taxes are taxes which are indirectly levied on the public through goods and services. The sellers of the goods and services collect the tax which is then collected by the government bodies.

- **Value Added Tax (VAT)**– A sales tax levied on goods sold in the state. The rate depends on the government.
- **Octroi Tax**– Levied on goods which move from one state to another. The rates depend on the state governments.
- **Service Tax**– Government levies the tax on service providers.
- **Customs Duty**– It is a tax levied on anything which is imported into India from a foreign nation.

Tax Collection Bodies:

The three bodies which collect the **taxes in India** have clearly defined the rules on what type of taxes they are permitted to collect.

- **The Central Government:**income tax, custom duties, central excise duty.
- **The State Governments:**tax on agricultural income, professional tax, value- added tax, state excise duty, stamp duty.
- **Local Bodies:** property tax, water tax, other taxes on drainage and small services.

GST:

In India, the three government bodies collected **direct and indirect taxes** until 1 July 2017 when the Goods and Services Act (GST) was implemented. GST incorporates many of the indirect taxes levied by states and the central government. What does the GST mean for your money?

Some of the taxes GST replaced include:

- **Sales Tax**
- **Central Excise Duty**
- **Entertainment Tax**
- **Octroi**
- **Service Tax**
- **Purchase Tax**

It is a multi-stage destination-based tax. Multi-stage because it is levied on each stage of the supply chain right from purchase of raw material to the sale of the finished product to the end consumer whenever there is value addition and each transfer of ownership.

Destination-based because the final purchase is the place whose government can collect GST. If a fridge is manufactured in Delhi but sold in Mumbai, the Maharashtra government collects GST.

A major benefit is the simplification of **taxation in India** for government bodies.

GST has three components:

- **CGST-**Stands for **Central Goods and Services Act**. The central government collects this tax on an intrastate supply of goods or services.
  (Within Maharashtra)
- **SGST:**Stands for **State Goods and Services Tax**. The state government collects this tax on an intrastate supply of goods or services.
  (Within Maharashtra)
- **IGST:**Stands for **Integrated Goods and Services Tax**. The central government collects this for inter-state sale of goods or services.

Other Government Bodies:

For a smooth implementation of the **Indian tax system**, there are bodies dedicated to it. Popularly known as the revenue authorities.

- **CBDT:**The Central Board of Direct Taxes is a part of the revenue department under the Ministry of Finance. It has a two-fold role. One, it provides important ideas and inputs for planning and policy with regard to direct tax in India. Second, it assists the Income Tax department in the administration of direct taxes.
- **CBEC:**The Central Board of Excise and Customs deals with policy formulation with regard to levy and collection of customs and central excise duties and service tax.
- **CBIC:** Post GST implementation, the CBEC has been renamed as the Central Board of Indirect Taxes & Customs (CBIC). The main role of CBIC is assisting the government in policy-making matters related to GST.
- Income Tax Department Income Tax Department functions under the Department of Revenue in MoF. It is responsible for governing the following direct taxation acts passed by Parliament of India. Income Tax Act Wealth Tax Act Gift Tax Act Expenditure Tax Act Interest Tax Act Various Finance Acts (Passed Every Year in Budget Session

Constitutional Provisions Governing Distribution of Tax The Constitution of India vests in itself the authority to levy a tax and assigns the power to levy various taxes between the Centre & the State. However, the Article 265 of the Constitution puts an important restriction on this power, that "no tax shall be levied or collected except by the authority of law". Therefore, each tax levied or collected has to be backed by an accompanying law, passed by either the Parliament or the State Legislature.

Article 246: Legislative Powers of Making Laws Article 246 of the Indian Constitution, allocates legislative powers, including taxation, between the Parliament & the State Legislature. Schedule VII lists these subject matters with the use of three lists; List - I entails the areas on which only the parliament can makes laws, List - II entails the areas on which only the state legislature can make laws, and List - III lists the areas on which both the Parliament & the State Legislature can concurrently make laws.

The tax-structure in India is well developed and the Constitution has made a clear distinction between the revenues of the Union & state governments, articulated in the form of three lists of – Union, State and Concurrent. In these lists, the power to levy taxes and duties is distributed as follows: Separate heads of taxation are provided under lists I and II. There is no head of taxation in the Concurrent List i.e., the Union & the States does not have simultaneous power of taxation. Given below is the list of 13 Union heads of taxation and the list of 19 State heads: (i) Union List It includes revenue sources that are the sole privilege of the Central Government. The taxes levied by the Central Government are: (REFER TO UNION LIST AT THE END)

(ii) State List State list includes sources of revenues that are the sole privilege of state governments. (REFER TO STATE LIST AT THE END)

(i) Concurrent List The concurrent list or list of local bodies includes: 1. Tax on Properties (buildings, etc.) 2. Octroi (tax on entry of goods for use or consumption within areas of the Local Bodies)

The revenue collected from taxes is distributed between the Centre & states in the following manner:

Central tax revenues only for the Central Government – the Central Government levies taxes and collects the revenues from such taxes (e.g. Corporate Tax, Tax on capital values of assets, which are a property, or Capital Gains Tax excluding land and Customs Duty). No part of the revenue collected through these taxes is transferred to the state governments.

Central tax revenues shared with the states – the Central Government levies taxes, but a part of the revenue is shared with the states (e.g., Income Tax and Central Excise Duty).

The Central Government levies taxes, but entire revenues are given to the states (e.g. Wealth Tax and Real Estate duty or Property Tax).

State tax revenues only for states – State governments levy and collect tax revenues (e.g., Sales Tax/VAT, Motor Vehicle Tax and Stamp Duty).